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BEFORE THE  
FEDERAL COMMUNICATIONS COMMISSION  
WASHINGTON, D.C. 20554

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In the Matter of )  
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Price Cap Performance Review for )  
Local Exchange Carriers )  
)

CC Docket No. 94-1

REPLY COMMENTS OF  
SOUTHWESTERN BELL TELEPHONE COMPANY

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March 1, 1996

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of  
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### Summary\*

In general, the Fourth FNPRM properly considers the issues concerning the adoption of a TFP approach in setting the productivity offset in the LEC price cap plan. Nevertheless, some parties continue to contend that the TFP approach should not be adopted, or in the alternative, argue that the TFP approach should be inappropriately skewed to suit the motives of those parties.

The Reply Comment phase of this proceeding comes at a crucial time for the industry. The recent passage of the Telecommunications Act of 1996 has mandated the promotion of competition and the reduction of regulation. Thus, the Commission should reject the attempts by those parties that want the Commission to limit competition by the LECs and increase regulation of the LECs in this proceeding.

The Commission has consistently held that price regulation should only be used until markets are competitive. Some parties (virtually all of which are now competitors with the LECs) argue for changes that would increase Commission regulation, contrary to the obvious fact that competition (by them and the LECs) now exists.

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\* All abbreviations used herein are referenced within the text.

SWBT fully supports the Reply Comments being filed on this same date by USTA. USTA's Reply Comments respond specifically to the flawed suggestions and errors placed on the record by those parties wishing to twist the Christensen TFP approach to their own purposes. SWBT herein also briefly responds to the key errors made by those parties.

In the Matter of )  
Price Cap Performance Review ) CC Docket No. 94-1  
for Local Exchange Carriers )

Southwestern Bell Telephone Company (SWBT), pursuant to the Fourth ENPRM<sup>1</sup>, hereby files its Reply Comments on the issues listed by the Federal Communications Commission (Commission). In these Reply Comments, SWBT responds to those parties that argue that the Commission should not adopt the total factor productivity (TFP) approach presented by the United States Telephone Association (USTA) for setting the productivity offset in the local exchange carrier (LEC) price cap plan. No party has raised any valid reason why the TFP approach, as proposed by USTA, should not be adopted expeditiously. Moreover, action on the Second ENPRM and Fourth ENPRM

<sup>1</sup> Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, (FCC 95-406) (Released: September 27, 1995) (Fourth FNERM). SWBT also responds herein to Issues 19 and 20 from the Price Cap Performance Review for Local Exchange Carriers, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice Of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393 (rel. Sept. 20, 1995). (Second FNERM).

consistent with the Telecommunications Act of 1996 (Act) is required.

I. THE TELECOMMUNICATIONS ACT OF 1996 PROVIDES KEY DIRECTION FOR THIS PROCEEDING.

The Act is based upon principles that provide a clear direction for the Commission's current considerations in this docket. First and foremost, the purpose of the Act, as stated in the initial lines of the statute, is to "promote competition and reduce regulation." In other words, regulation should be reduced in favor of the unobstructed and undistorted workings of the marketplace. Regulatory rules should be fewer, simpler and more adaptive to market changes.

Second, the pace of change in the telecommunications industry, as recognized in the various modifications by the Act to prior regulatory schemes, demands that changes to the LEC price cap plan also be bold and expansive. The Act will certainly promote further rapid changes in the industry. Thus, the Commission must dramatically increase the pricing flexibility and structural flexibility in the regulation of LECs to keep in step with these dramatic changes. The provisions of the Act on various subjects are clearly designed to allow all providers a more equal opportunity to address the needs of telecommunications customers in

all markets. The Commission should not act inconsistently with this principle.<sup>2</sup>

A. LEC Price Cap Reform Can Fit Neatly Into Congress's Mandate.

The implications of the Act for the issues in the Second FNPRM and the Fourth FNPRM are apparent. The long overdue reforms proposed in the Second FNPRM are now more imperative. Clearly, the claims<sup>3</sup> that the Commission can postpone the fundamental reforms addressed in the Second FNPRM until it finishes the Fourth FNPRM issues (and until dockets mandated by the Act are completed) are flatly wrong.

The LECs' competitors wish to have the Commission maintain the existing archaic rules that prevent the exact kind of aggressive competition anticipated by the framers of the enacted

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<sup>2</sup> Section 706, Advanced Telecommunications Incentives, explicitly states that the Commission shall use regulating methods, such as price caps, that remove barriers to infrastructure investments. This section of the Act excludes ROR regulation from its discussion of such regulatory methods.

<sup>3</sup> See the February 16, 1996 issue of the Washington Telecom Week, p. 11, quoting representatives of AT&T, MCI, Ad Hoc, CFA, others -- that they will light a bonfire under the Commission and that their "full wrath" will come down on the Commissioners unless the Commission changes its "misguided naivete" and promptly mandates further reductions in LEC access charges. These participants wish to have the Commission further delay any meaningful consideration of the important issues raised in the Second FNPRM.

legislation.<sup>4</sup> The Commission cannot continue to protect the LECs' competitors from competition by the LECs; the Commission must act now to permit the head-to-head price and service competition envisioned by the Act. Prompt Commission action on the Second FNPRM and Fourth FNPRM consistent with the Act is required.

Consideration of the interrelationships between the issues raised in the Second FNPRM and the Fourth FNPRM is now more critical than ever. Punitively high levels for the X-factor, the continued imposition of earnings sharing, other means of hamstringing the price cap LECs -- all proposals suggested by the LECs' competitors -- create obstructions and distortions completely contrary to the intent of the Act. The LECs' competitors have submitted filings and consultant studies with policy recommendations which, if adopted, would have ruinous effects on the objectives of the Act.

The Commission must disregard the "we win/they lose" proposals submitted by AT&T, MCI and others.<sup>5</sup> The regulatory

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<sup>4</sup> SWBT Reply on the Second FNPRM dated January 10, 1996 and filed on January 16, 1996 (due to the Commission's closure) describes the fact that virtually all of the oppositions to SWBT's position in this proceeding comes directly from the LECs' competitors. See pp. 1-2, and fns. 3-5.

<sup>5</sup> These parties essentially suggest that certain parties (e.g., the shareholders of AT&T, MCI) be conferred windfall gains at the expense of the LEC industry and the general body of  
(continued...)



scheme for the LECs must be lightly and carefully applied so as to not skew the market signals that drive investment decisions. Despite the wishes of the LECs' competitors, the Commission cannot place itself in the role of picking which telecommunications providers will succeed in the newly competitive markets by imposing or retaining pricing umbrellas or other artificial constraints on the LECs. The LECs are an important group of competitors, too valuable to the competitive process to be constrained in such a manner.

B. The Basic Objectives for Price Cap Reform Should be Followed.

The two fundamental means by which telecommunications firms have traditionally been motivated or required to pass on the benefits of productivity growth to their customers are: (1) competition; and (2) regulation. In this proceeding, the Commission is weighing how to utilize these means. The Commission must be prudent in its decision. If the Commission were to craft a "permanent" LEC price cap plan that relied on profit regulation or even a combination of competition and price regulation in any

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<sup>5</sup>(...continued)

consumers of telecommunications services, through their proposals which would unreasonably require drastic LEC access price reductions.

specific LEC market, it would be harmfully over-regulating the LECs.

The Commission has consistently held that overall price regulation is preferable to cost-plus (or rate of return (ROR)) regulation. The Commission must act now to remove all cost-plus regulation from the LEC price cap plan, and implement instead the form of regulation previously applied to AT&T and the cable TV companies. All aspects of explicit regulation of LEC profits should be removed.

The Commission has consistently held that explicit regulation of prices should be retained only as long as competitive market forces are not present. Thus, price cap regulation is the proper transition to competition, and should not be used in those markets that are competitive. These principles are consistent with the Act. The LECs' competitors, however, would prefer that the Commission impose increasingly restrictive regulation on the LECs at just the time when competition should be replacing explicit regulation.

When the Commission first considered adopting price cap regulation as an alternative to ROR regulation, its objective was to substitute one form of regulation for another. Explicit regulation of overall price levels was to replace explicit regulation of ROR earnings. In fact, the Commission adopted "pure"

forms of price cap regulation (without ROR constraints) for AT&T and for cable TV companies, and allowed other classes of telecommunications providers -- for example, other interexchange carriers (IXCs) and competitive access providers (CAPs) -- to be treated as nondominant carriers with no regulatory pricing or earnings constraints.

By contrast, the LEC price cap plan adopted in 1990 and under review in this proceeding combines explicit price regulation with explicit earnings regulation. The Commission described its 1990 decision to include explicit earnings sharing in a plan that also included explicit price constraints as "an even more cautious and careful approach," and a "backstop." This addition of earnings regulation to price regulation was a "belt and suspenders" approach. Such an approach has not been used for the regulatory plans adopted for AT&T, the cable TV companies, IXCs or CAPs. It is time for the Commission to bring the regulation of the price cap LECs into parity with the regulation of these other carriers.<sup>6</sup> The principles of the Act demand nothing less.

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<sup>6</sup> By parity of regulations SWBT means regulation that, while recognizing differences in markets, applies the same regulation to all carriers facing similar market conditions.

II. SOME PARTIES HAVE MADE BASIC ERRORS IN THEIR COMMENTS ON THE COMMISSION'S X-FACTOR PROPOSALS.

The productivity factor is an integral part of LEC price cap regulation. As such, the productivity factor should be seen as a tool to be used to flow-through the benefits of productivity gains to consumers, while preserving the profit incentives that foster such further productivity gains. A number of the parties, however, wish to turn the "tool" into a weapon. They want to have the Commission use that weapon to force the price cap LECs into further drastic price reductions. In particular, Ad Hoc wishes to use the productivity factor as a sword to chop LEC earnings, and MCI wishes to use it as a club to beat rates down to remove what MCI calls "uneconomic" costs.<sup>7</sup>

The Commission must reject the attempts by these and other parties to twist this proceeding into one that serves only the agendas of those parties. Instead, the Commission should focus on ensuring that the productivity factor properly flows through the benefits of productivity gains to consumers, while preserving the

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<sup>7</sup> See also, SWBT's Reply on the Second FNPRM, dated January 10, 1996, filed January 16, 1996 (due to the Commission's closure), pp. 14-15.

profit incentives that foster such further productivity gains.

Several commentators make misguided suggestions regarding the productivity study filed by USTA on behalf of the price cap LECs. USTA will specifically respond in its Reply Comments to be filed on this date to these flawed suggestions and errors placed on the record. In particular, USTA responds to Dr. Norsworthy's filing made on behalf of AT&T, the Selwyn/Kravtin filing made on behalf of Ad Hoc and the Baseman/Gieson filing made on behalf of MCI. SWBT fully supports the USTA Reply Comments.

A. The X-factor Proposals of AT&T and Ad Hoc Contain Basic Flaws.

The following points demonstrate that the policy recommendations of AT&T and Ad Hoc regarding the level of the X-factor are completely inappropriate:

- AT&T's so-called "performance-based" model retains many of the flaws of its previously discredited historical revenue model. AT&T's current model (like its closely-related historical revenue model) is based on outdated ROR regulation concepts designed to explicitly regulate the LECs' accounting ROR. Thus, AT&T's "performance-based" model should be likewise rejected.<sup>6</sup>

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<sup>6</sup> USTA Reply Comments filed March 1, 1996, Attachment B, "Economic Evaluation of Selected Issues from the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review: Reply Comments," William E. Taylor, Timothy J. Tardiff and Charles J. Zarkadas, National Economic Research Associates, Inc. (NERA Reply), pp. 3-5.

- AT&T is wrong that the X-factor must be based on interstate TFP estimates. This change would shake the foundation of all of the Commission's prior price cap decisions. The Commission has consistently used national inflation adjustments paired with total industry (or total company) productivity factors. If AT&T's flawed claim were valid, which it is not, then the AT&T price cap plan could not have been implemented as it was.
- AT&T and Ad Hoc made flawed attempts to measure interstate productivity. Both Norsworthy and Selwyn/Kravtin wrongly and arbitrarily allocate the joint and common LEC costs to the intrastate and interstate jurisdictions by meaninglessly assuming that cost growth is equal in both jurisdictions.<sup>9</sup> These parties cannot justify these arbitrary assumptions which incorrectly overstate the proper X-factor.
- Both Norsworthy and Selwyn/Kravtin incorrectly measure LEC capital costs, inappropriately departing from accepted economic theory and productivity measurement methods.<sup>10</sup> Because the capital section of the Norsworthy model is wrong, it cannot form the basis for X-factor determination.<sup>11</sup>
- Norsworthy and AT&T heavily and improperly rely on the arbitrary fluctuations observed in the LECs' reported accounting expenses and returns.<sup>12</sup> Because these accounting measures fluctuate for many reasons not related to underlying productivity growth, the AT&T productivity estimates must be rejected. Proper determination of underlying productivity must rely on

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<sup>9</sup> USTA Reply Comments, Attachment A, "Reply Comments of Christensen Associates," Lauritis R. Christensen, Philip E. Schoech, and Mark E. Meitzen Christensen Reply, pp. 4-6. See also, USTA Comments, Attachment C, (NERA Comments), filed January 16, 1996, pp. 14-21.

<sup>10</sup> (Christensen Reply), pp. 12-15.

<sup>11</sup> Christensen Reply, pp. 13-17; NERA Reply, pp. 5-12.

<sup>12</sup> NERA Reply, pp. 8-11.

meaningful economic measures, such as were employed by Christensen on behalf of USTA.

- Norsworthy raises other "red herrings." His suggestion that Christensen should have used a Fischer Ideal Index is a charade because its use leaves the results unchanged.<sup>13</sup> The Commission must likewise ignore his suggestion that Christensen should have used marginal cost weights to measure composite output growth because Norsworthy's suggestion has been proven theoretically incorrect, cannot be implemented with public data, and would incorrectly lower the estimated X-factor.<sup>14</sup>

Thus, the X-factor proposals of AT&T and Ad Hoc are wrong.

B. USTA's Opponents Have Used Flawed Data in the Debate on the Input Inflation Differential.

Until the Christensen Simplified TFP Study<sup>15</sup> was completed, no party to this proceeding has had the opportunity to analyze the input inflation differential with an appropriately consistent set of data for both the LECs and the U.S. economy. With the filing of the current Christensen study on January 16, 1996, the Commission now has available a set of TFP data and input inflation data where the fundamental productivity measurement

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<sup>13</sup> Christensen Reply, pp. 7-9, Table 2.

<sup>14</sup> Christensen Reply, pp. 12-13; NERA Reply, pp. 25-27.

<sup>15</sup> USTA Comments, filed January 16, 1996, Attachment A (Christensen Simplified TFP Model). See also Attachment B, Total Factor Productivity Review Plan, containing all data and calculation that underly the Christensen Simplified TFP Study described in Attachment A.

methods and the secondary input inflation measurement methods all use more consistent approaches.

SWBT supports the analogy describing this issue that was presented by Lincoln Telephone in its January 1996 Comments in this proceeding:

The original Christensen Study was developed to produce an accurate measure of productivity but not to produce a meaningful measure of input prices. An analogy could be the waste water from a nuclear power plant. It is a by-product of the process, but you wouldn't want to drink it. It is inappropriate to use the original Christensen study to calculate LEC input price changes because it was not designed to produce economically valid measure of input prices. Input prices are merely a by-product of the process.<sup>16</sup>

Lincoln is correct. The previous estimate of the LEC input inflation differential attributed to the original Christensen Study -- eventually derived from data embedded within the Christensen data and that used U.S. economy data and methods considered by the original Christensen study methods -- was never intended for regulatory consumption.

The selection of methods and data in the original Christensen study<sup>17</sup> did not contemplate and was never intended to produce a LEC input inflation data series that could accurately and

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<sup>16</sup> Lincoln, p. 4 [footnote omitted].

<sup>17</sup> This includes the data associated with the original Christensen TFP study filed in this docket as Attachment 6 to USTA Comments on May 29, 1994 and the "1993 Update" to the Christensen TFP Study filed as a USTA ex parte on January 20, 1995.



consistently be compared to a U.S. input inflation series for the purposes of determining a LEC-minus-U.S. differential. Had the Commission established input inflation differential as a primary objective of the 1994 LEC Price Cap Review proceeding in its January 1994 NPRM, it is possible that Christensen Associates would have approached its original study design with somewhat different methods and data.<sup>18</sup> This is because the selection among available alternative correct TFP methods and data sources can have an effect upon the degree of consistency between the two measures of input inflation (LEC and U.S.) used to compute an estimate of the differential. However, because the input inflation estimates play a rather minor role in the estimate of overall TFP, alternative correct TFP methods and data that affect input inflation estimates typically have little if any material effect on the estimate of LEC TFP.<sup>19</sup>

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<sup>18</sup> Recall that the January 20, 1995 update was an update of the original Christensen study. The basic design of the original Christensen Study was established in the Fall of 1993; data collection, calculation and final methods decisions were finalized in the Spring of 1994.

<sup>19</sup> This fact is particularly true for capital input prices because the TFP method computes both capital input quantities and capital input prices. Proper TFP methods correctly and completely reject the estimates of capital-related expenses shown on the LECs' regulatory accounting books (i.e., accounting depreciation and amortization expenses) because they are notoriously inaccurate and inappropriate measures of the total capital-related expenditures (continued...)

C. Opponents of the Christensen TFP Approach Have Made a Number of Errors Specific to the Input Inflation Differential Issue.

The following errors made by AT&T and Ad Hoc are specific to the issue of the lack of appropriateness of the input inflation differential. These errors are discussed in more detail in the attachments to the USTA filing made on this date:

- Both Norsworthy and Selwyn/Kravtin support undocumented and highly speculative increases to the X-factor based on so-called "hedonic" adjustments. Hedonic adjustments, if they were observable and verifiable, would theoretically represent the effects of quality improvements on the measurement levels of prices and quantities.<sup>20</sup> Neither AT&T nor Ad Hoc, however, present any justification for, or credible evidence in support of, any of the specific speculative "hedonic" increases in the X-factor that they suggest.<sup>21</sup> The selfish "hedonisms" of AT&T and Ad Hoc distort their measurements of X and must be scrapped.

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<sup>19</sup>(...continued)  
necessary for a reliable measure of TFP.

<sup>20</sup> The ad hoc adjustments suggested by Norsworthy and Selwyn/Kravtin are not proper applications of the hedonic (or quality-adjusted) concepts.

<sup>21</sup> If the hypothesized increased "quality" of inputs generates additional outputs, then the use of deflated revenues in the Christensen TFP approach will generally already account for those increased outputs. For example, the fact that digital switches and switch generic software upgrades (inputs) facilitate the sales of custom calling features and other CLASS services (outputs) is explicitly captured by the measure of local services output -- local service revenues (which already include any and all increases in CLASS revenues) are deflated by the local service price index, resulting in higher output growth and higher TFP. In this example, no explicit "hedonic" adjustments are appropriate. In fact, Selwyn/ Kravtin's including them is wrong because it incorrectly double counts "quality" improvements.

- Selwyn/Kravtin one-sidedly increase the X-factor based upon their speculative "hedonic" adjustments made to the input price side of their calculations, but they do not make the corresponding reductions to the TFP side of their calculations that their approach would require. As a result, Ad Hoc has further biased the presentation of their already biased approach. The Commission must reject Ad Hoc's "hedonic" addition factor.
- Norsworthy recommends a totally incorrect statistical test for determining whether the input inflation differential has been zero in the past.<sup>22</sup> As a result, AT&T asks the Commission to test the wrong question. The results from AT&T's test of an irrelevant question in the past has no relevance for the X-factor in the future and should be ignored.

As a result, the recommendations of AT&T and Ad Hoc based on inconsistent and biased input inflation must not be considered.

III. MCI PRESENTS A CONSULTANT DOCUMENT RELATING TO DEPRECIATION THAT MUST BE TOTALLY DISREGARDED.

MCI presents a document prepared by MicRA that claims to analyze the appropriateness of the Commission's depreciation prescriptions for LECs. MicRA's report flatly does no such thing.

- MicRA assumes the answer to the question that it purports to investigate. Using circular logic, MicRA uses depreciation reserve calculations based on FCC prescribed

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<sup>22</sup> NERA Reply, pp. 12-14. AT&T incorrectly recommends a chi-square test for equality of sample distributions (i.e., the equality of variance, the degree of skewedness, and essentially the "compactness" of the observed variation around the mean for a given degree of variance), rather than the proper t-test for equality of sample means (in this case, the average growth rates). The test that AT&T recommends has absolutely no relevance in determining the X-factor.

lives to test the appropriateness of those same lives. MicRA performs no analysis of the accuracy or the realism of the FCC prescribed lives.<sup>23</sup>

The FCC must totally disregard MicRA's document and any implications that MCI or any other party might draw from the erroneous conclusions in the MicRA document.

#### IV. CONCLUSION

For the foregoing reasons, SWBT respectfully requests that the Commission adopt the Christensen TFP approach to set the

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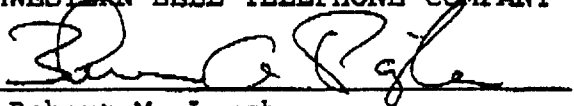
<sup>23</sup> See Appendix A, "SWBT's Response to the MicRA Report; and USTA Reply Comments, Attachment D, "Implications of Technology Change and Competition on the Depreciation Requirements of the Local Exchange Carriers," Adrian J. Poitras and Lawrence K. Vanston, Technology Futures, Inc.

productivity offset in the LEC price cap plan, and that other proposals that skew the results of the TFP approach or eliminate incentives from price cap regulation should be rejected.

Respectfully submitted,

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March 1, 1996

### **SWBT's Response to the MiCRA Report**

MiCRA prepared a report, titled Depreciation Policy in the Telecommunications Industry: Implications for Cost Recovery by the Local Exchange Carriers, on behalf of MCI. Simply stated, MiCRA concludes that FCC regulation has not caused under-depreciation of the LECs' assets and the LECs do not have a depreciation problem. The MiCRA report, however, is inaccurate, superficial, and misleading. In fact, the LECs' regulated depreciation lives are too long, their regulated reserves are deficient, their regulated depreciation expense has been understated, and, as a consequence, their past earnings have been over-stated, all because of the past regulation of depreciation.

#### **The theoretical reserve as an indication of a depreciation problem.**

As a means of determining the existence of a LEC depreciation problem, MiCRA calculates a "theoretical reserve" amount for the major LECs.<sup>1</sup> MiCRA simplistically concludes that, since MiCRA's theoretical reserve calculations show no significant reserve deficiency (when compared to the LECs' book reserves), then there is obviously no depreciation problem. This could appear to be a convincing argument, if only it were not based on totally wrong assumptions and circular logic.

The theoretical reserve is simply a calculated amount of reserve that would have existed on the LECs' books today if the "current" life and salvage parameters had been in place since the beginning.<sup>2</sup> By far, the most critical components of this calculation are the lives.

MiCRA assumes that the appropriate lives to be used in the theoretical reserve calculation are those currently prescribed by the FCC. Using the FCC's currently-prescribed lives in its calculation, and comparing the result to the LECs' book reserves, MiCRA determines a theoretical reserve deficiency of only about \$3 billion for the major LECs. MiCRA then concludes, based on this calculation, that the LECs have no depreciation problem (i.e., that the regulatory lives have been adequate for the LECs).

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<sup>1</sup> MiCRA omits the following price cap LECs from its analysis: GTE, Sprint, LTD, SNET, Lincoln and Frontier.

<sup>2</sup> "Current" in this sense does not necessarily mean proper.

However, it is these very lives that cause MiCRA's calculation of the theoretical reserve deficiency to be as low as it is. In other words, MiCRA assumes that the FCC's lives are correct in order to prove that the FCC's lives are correct. Therefore, MiCRA's approach is circular logic, and proves nothing. Hence, MiCRA's conclusion is erroneous. In fact, these regulatory lives are precisely the cause of the LECs' depreciation problem.

Also, MiCRA refers to the fact that its calculations are corroborated by the LECs' own theoretical reserve calculations filed annually with the FCC. Either MiCRA is unaware, or chooses not to point out, that the FCC requires these annual filings to be based on the FCC's prescribed lives, not the lives the LECs believe to be proper. Thus, MiCRA has proved nothing.

Further, MiCRA refers to a similarly "insignificant" \$5 billion theoretical reserve deficiency for the LECs, based on life proposals made by the LECs to the FCC during the period from 1992 to 1994. In this instance, MiCRA assumes that the LECs' life proposals have not changed from those submitted in the 1992-1994 time-frame. However, this is also an invalid assumption. Much has changed in the telecommunication industry even since 1992. More regulatory and legislative measures promoting competition have emerged since 1992. More technology advances have occurred since 1992. If MiCRA had wanted to use a period of time more representative of the LECs' current views of their assets' lives, they would have chosen the last couple of years, during which most all major LECs evaluated their depreciation problems in connection with the discontinuance of FAS 71 for external financial reporting.

Regulatory-prescribed lives have historically been too long.

Regulatory lives have consistently been overstated. Even the FCC's past actions have clearly acknowledged this problem. For example, in the mid-1980s, the FCC recognized that even their recently-adopted remaining life depreciation method would not eliminate the LECs' reserve deficiencies that had been built up by inadequate lives and methods, in a timely manner. Unfortunately, when the FCC allowed the LECs to amortize this reserve deficiency over five years, it understated the size of the deficiency by using the lives prescribed at that time to calculate a theoretical reserve level.

The FCC also recognized that past lives sometimes create significant reserve imbalances as the corresponding plant balances approach zero. To remedy this type of

situation, the FCC adopted special procedures for "dying accounts"<sup>3</sup>. The most obvious example of the LECs' past need for this type of remedy was in electromechanical switching. Both the LECs' life proposals and the FCC's life prescriptions for electromechanical switching did not properly predict the eventual rapid displacement of this technology. Had the demise of electromechanical switching been recognized early enough, then the extraordinary effort to catch-up the reserves (i.e., the amortization of the reserve deficiencies for these dying accounts) would not have been required.

Further evidence of the FCC's acknowledgment that past lives have been too long is their acceptance of somewhat shorter lives in the last few years. However, even these shorter lives are generally much longer than those proposed by the LECs. Since the FCC has not accepted the LECs' shorter life proposals, which more accurately and more realistically reflect the usefulness of their plant in the current environment, it is highly likely that dying account amortization will also be required in the future. However, even though this type of procedure was somewhat more acceptable in the industry in the past, these extraordinary, and often after-the-fact, reserve catch-ups are not appropriate in the competitive environment of today and the future, since they unfairly disadvantage the LECs.

The remaining life method of depreciation does not solve the LECs' reserve problems.

The MiCRA report claims that problems simply do not and will not exist in the LECs' reserves, because of the FCC's adoption of the "remaining life" depreciation method. It should be immediately acknowledged that the remaining life method is far superior to the FCC's prior "whole life" method. Under whole life, any reduction in prescribed life would cause future depreciation accruals to reflect the new life, but nothing was done to compensate for all of the past under-accruals caused by the old overstated life (or lives). Remaining life, on the other hand, builds this compensation or catch-up into the future accruals. Therefore, its self-correcting nature is a vast improvement over whole life. However, even remaining life is plagued by two faults:

- Remaining life only corrects (in the future) those changes in lives that have already occurred. It does not anticipate future changes in lives and the further accrual corrections that those future life changes will require. Thus, remaining life is only a reactive method, not proactive. This is critical because: (a) history has shown that the FCC's past life prescriptions have been too long (therefore, requiring subsequent, but much too gradual, life reductions and/or special dying account

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<sup>3</sup> Dying account amortization was introduced by the FCC in its 1983 triennial represcription Order, FCC 83-587, starting at paragraph 42.



amortization to dispose of the associated reserve deficiencies); and (b) it is reasonable to expect the FCC to have to make further life reductions in the future.

- Even for a life reduction that has already occurred, and for which remaining life is already compensating, remaining life will not achieve the needed catch-up in the reserve until the very end of the life of the account. This catch-up period could be much longer than is reasonable for the LECs' assets to be properly reserved. For example, based on lives presently prescribed by the FCC, this catch-up period is as much as 10 to 15 years into the future for copper cable. This is significantly longer than the catch-up period associated with the simple example of remaining life in the MiCRA report.

**Shorter asset lives are appropriate for SWBT and the other LECs now.**

The LECs use several forecasting techniques to predict the lives of their major asset categories. These include life cycle, technology substitution, and other forms of analyses. The LECs' life forecasts are generally consistent not only with each other, but also with the studies prepared by Technology Futures, Inc. (TFI). The TFI studies use past and present evidence of the actual substitution of older technologies by newer technologies to forecast the lives of the LECs' present assets. The TFI studies also address the impact of competition on the cash flows that the LECs' present networks can be reasonably expected to generate in future years (and hence, the impact of competition on the useful lives of these network assets). TFI's studies are described further in an attachment to USTA's Reply Comments in the immediate proceeding. SWBT fully supports the USTA Reply Comments and the TFI study entitled "Implications of Technology Change and Competition on the Depreciation Requirements of the Local Exchange Carriers," included there as Attachment D.

One of the most relevant aspects of the LECs' analyses and TFI's studies is the distinction between the physical retirements of assets and the usefulness of those same assets. The FCC has placed considerable reliance on the LECs' historical retirements, as well as their budgeted retirements three years into the future, to prescribe lives. The LECs and TFI, on the other hand, determine more-realistic lives by assessing the future usefulness of the assets, based not on physical retirements, but instead, on such factors as the pace of customers' migration off of those assets, the future cash flows which can be generated by those assets, and the actual substitution of newer technologies for those older assets. This important distinction between physical retirements and future usefulness recognizes, for example, that all large copper cables may: (a) gradually lose the use of their pairs over the next ten to fifteen years; and (b) not be physically retired until ten to fifteen years from now. Lives improperly determined by physical retirements incorrectly appear to be very long until the last few